United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-5008

In The

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B P/S

JOSEPH S. CARGES, as trustee in bankruptcy of Paul R. Dean & Co. Inc.,

Plaintiff-Appellant,

vs.

AETNA CASUALTY AND SURETY CO.,

Defendant-Appellee.

BRIEF OF DEFENDANT-APPELLEE

WINCHELL, CONNORS AND CORCORAN
Attorneys for Defendant-Appellee
45 Exchange Street
Rochester, New York 14614

On the Brief:
RICHARD H. CONNORS

Daily Record Corporation
Rochester, New York

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Syracuse, New York

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Statement of the Case

An action was brought by the trustee in bankruptcy of the Paul R. Dean & Co. Inc., to recover on two broker's blanket bonds issued by defendant Aetna Casualty & Surety Co.

The case was tried before the Honorable Harold P. Burke, United States District Judge in the Western District of New York on July 7, 8 and 9, 1975. The trial resulted in a judgment in favor of the defendant dismissing plaintiff's complaint.

From this judgment the plaintiff has appealed.

Facts

At all times pertinent to this case Paul R. Dean & Co. Inc., (hereinafter Dean Company) was a closely held corporation. The sole stockholders and directors were Paul R. Dean and John Nichols, each holding 50% of the outstanding stock. (T. 145)*

Dean Company specialized in municipal bond transactions. Paul Dean had formerly been associated with Bonbright & Company, brokers. Nichols was a lawyer who discontinued the practice of law and became a "private investor". (T. 139)

The New York General Municipal Law, Section 106 permits contractors for municipalities and other similar public corporate, such as school districts, to deposit municipal bonds in lieu of cash retainages, permitting them to obtain interest on the retained amounts. (Ex 1, Stips. 15, 16, 17)

Pursuant to that provision, the City of Rochester from June 1970 through April 1973 delivered to the Dean Company about $2,000,000.00 in payment for bonds which the Dean Company was to buy and hold pursuant to the above section, and contractors with the Penfield Central School District delivered over $37,000.00 for the same purpose to the Dean Company. (Ex 1, Stip. 17)

There was no evidence that the Dean Company ever purchased these bonds.

The Dean Company books were maintained in an orderly and proper manner and were essentially a good set of corporate records. They showed that substantial loans were made by the Dean Company to Paul R. Dean and John Nichols. All transfers of monies from the Dean Company to Paul R. Dean or John Nichols or to others were recorded in the company books. (T. 104)

*Numbers refer to pages of the trial transcript.

On October 15, 1966 the defendant Aetna Casualty and Surety Co. (hereinafter Aetna) issued a broker's blanket bond Number 45F1259BC to the Dean Company. This bond was cancelled on October 15, 1971 and a new bond Numbered 45F1526BCA was issued. (T. 48) The original bond applied to losses discovered prior to the termination or cancellation of the bond. Since the original bond was cancelled on October 15, 1971 and the appellant makes no claim of having discovered any loss prior to that time, we are concerned here only with the provisions of the new bond.

Following are pertinent terms of the bond: (Attachment B annexed to complaint)

The new bond issued October 15, 1971 had a $250,000.00 limit of liability. It is the standard broker's blanket bond form 14 used throughout the insurance industry. The insured is Paul R. Dean & Co. Inc. The bond provides coverage for loss occasioned by the dishonest or fraudulent act of employees and sustained by the insured at any time but discovered during the bond period.

The bond provides for termination "immediately upon the taking over of the insured by a receiver or other liquidator, or by State or Federal officials" (Section 10 (d)). It also provides for termination as to any employee "immediately upon discovery by the insured of any dishonest or fraudulent act on the part of such employee" (Section 10). The bond also provides as follows:

> "Section 4. This bond is for the use and benefit only of the insured named in the declarations and the underwriter shall not be liable hereunder for loss sustained by anyone other than the insured unless the *insured* in its sole discretion and at its option shall include such loss in the insured's proof of loss. At the earliest practicable moment after discovery of any loss hereunder, the insured shall give the underwriter written notice thereof and shall also within six months after such discovery

> furnish to the underwriters affirmative proof of loss with full particulars."

Section 2 of the bond provides certain exclusions from coverage. Losses resulting from trading are not covered. Losses resulting from loans obtained from the insured or any of its partners, directors or employees, whether authorized or unauthorized, are not covered.

The bond does *not* cover (Section 2 (d))

> "loss resulting from any act or acts of any person who is a member of the Board of Directors of the insured or a member of any equivalent body by whatsoever name known unless such person is also an employee or an elected official of the insured in some other capacity, nor, in any event, loss resulting from the act or acts of any person while acting in the capacity of a member of such Board or equivalent body; or loss resulting from any dishonest or fraudulent act or acts of any partner of the insured".

POINT I

Paul Dean was not an employee within the meaning of the bond, but was, in fact, the insured.

For all intents and purposes, Paul Dean was the Dean Company and not an employee.

Paul Dean and John Nichols each owned 50% of the stock of the Dean Company, and were the only directors of the Company.

John Nichols testified at the trial that he was an investor, and knew nothing about the bond business, and took no part in the running of the Dean Company. (T. 162)

John Nichols testified as follows: (T. 376)

> "Q. As far as the general day to day run of the bond business and the purchase and sale of municipal bonds,

I gather that the situation was that this was done by Paul Dean, and you left that to him, is that correct? A. Yes.

Q. Whatever he did in that connection I assume was with your approval as a director and stockholder of the corporation? A. Yes.

Q. When you had occasion to discuss matters of this sort with him, you left it up to him as the manner in which he operated that part of the business? A. It was his company. He was the President, and I relied on his judgment and what he told me.

Q. As far as you were concerned, Paul R. Dean was the Paul R. Dean & Co., is that right? A. That's right."

It is the basic tenet of the law that one cannot insure himself against losses caused by his own fraud.

(See Frauds of the Insured by John McCormack, The Forum, Volume IV No. 3, Page 204; Phoenix Savings and Loan, Inc. v. Aetna Casualty and Surety Company, 266 Fed Supp, 465 (1966) Page 473, reversed on other grounds, 381, F 2d, 295; West American Finance Company v. Pacific Indemnity Company, 17 CA 2d, 225, 61 P2d, 963;

Couch on Insurance 2d, Section 46:238.

The existence of an employer/employee relationship has been sustained where the insured has control over the activities of the alleged employee. Conversely, the fact that the insured has no control over the conduct or operation of the alleged employee has been held to negate the existence of an employer/employee relationship.

35 Am. Jur. 2d, Pages 512 to 513.

Certainly, Dean & Company had no control over Paul Dean, but rather Dean controlled the Dean Company and was its sole operating entity.

John Nichols concededly did not control the conduct or the operation of Dean. He, in fact, testified that he agreed to and ratified the acts of Dean and in his capacity as director and stockholder approved of Dean's acts. Indeed, John Nichols accepted the benefits of Dean's acts.

Nichols and Dean both took loans from the Dean Corporation. (T. 171) Both Dean and Nichols took $125,000.00 each from the Dean Company and invested in the Sande Broadcasting Company. They each received 350 shares of Sande Broadcasting Company stock in their own names (T. 184).

Dean and Nichols were the sole shareholders and only directors of the company. They elected themselves officers and, therefore, were technically covered under the fidelity bond defining employee to include officers.

However, in *Kerr v. Aetna Casualty and Surety Company*, 350 F 2d, 146 (1965) the court noted that technically as directors they probably had the right to control themselves as officers, but that such a theoretical and unrealistic right of control did not make the men covered by the bond. Such a bond was not intended to cover the fraud and dishonesty of men who are, in effect, the sole stockholders as well as the only directors of *a closely held corporation.*

The bond was not intended to cover the fraud of the directors, but to protect the corporation from the fraud of its employees, and was not to protect creditors from the fraud of directors.

> *Kerr v. Aetna Casualty and Surety Company* supra
>
> *Kelly, Andrews & Bradley v. USF&G*, New York Law Journal April 1, 1975 (The *Kelly, Andrews & Bradley v. USF&G* decision is attached hereto as Exhibit A since it is not available in any official reports at this time)

The *Kelly, Andrews & Bradley* case mentioned above involved the identical Form 14 coverage involved here and even in the same amount.

It was held in *Phoenix Savings & Loan v. Aetna Casualty & Surety Company*, 266 F Supp 465 (1966) P. 473, "Where individuals have organized a corporation to line their own pockets, and where they control substantially all of the activities of the corporation, their knowledge of the fraudulent nature of each and every questioned transaction must be imputed to the corporation."

And it has further been held, "In case the business or transaction in question is intrusted to an officer or agent of the corporation who acts as its only authorized agent, then, although such officer in transacting the business acts for himself or if interested in the transaction adversely to the corporation, under such circumstances his knowledge is imputable to the corporation, for the reason that the officer is necessarily acting for the corporation in his official capacity and as its sole authorized agent and hence his knowledge must be imputed to the corporation."

Fletcher Cyclopedia Corporations (Perm Ed Vol 3 Sec 827 PP 151-154)

Fed. Dep. Ins. Corp v. Vest, 28 F. Supp 507

Curtis v. Connly, 257 U.S. 260, 42 S Ct 100

Mutual Life Insurance Co. v. Moreman, 366 F 2d, 686, 690

The Effect of Discovery of Loss by Francis L. Kenney, Jr. in Proceedings 1967 of Section of Insurance, Negligence and Compensation Law of American Bar Association. (Comprehensive and thorough analysis of a similar loss situation by Francis E. Kenney, Jr. referred to above is attached hereto as Exhibit B since it is not otherwise readily available.)

POINT II

There was no covered loss within the meaning of the bond.

The proof at the trial was to the effect that Dean Company received money from the City of Rochester and other contractors for the purpose of purchasing municipal bonds, which the Dean Company was to hold for the owners. There was no proof that the bonds were purchased.

The money received from the City of Rochester and others was deposited in the regular accounts of Dean Company (T 92).

From time to time the Dean Company made loans and advances of salary to Paul Dean and John Nichols and to others. (T 93). Every transaction was recorded in the books of the Dean Company.

Stanley Dye, the accountant retained by the trustee in bankruptcy, testified at the trial that the corporate books were maintained in a normal, orderly fashion and were a good set of corporate books (T 104). They showed that all money received went into the Dean Company account (T 104).

The fact that Dean or Nichols may have used the money that was loaned to them by the corporation for gambling purposes or whatever, has nothing to do with the bond.

The issue is whether there was a loss to the insured Dean Company, not whether there was a loss by the company's creditors.

The bond is to protect against loss to the insured not the losses of third parties.

Several of the cases cited by Appellant in his brief are authority for the proposition that there was no covered loss in the instant case.

The case of *Fidelity and Deposit Company of Maryland* vs. *Usaform Hail Pool, Inc.*, 318 F Supp 1301 was reversed on appeal at 463 F 2d, 4, the appeals court determining that there could be no recovery under the bond, and that the bond was written to protect against loss to the insured, and not to losses of third parties.

The case of *In Re Schluter, Green & Company*, 93 F 2d, 810 also cited in Appellant's brief, involved a situation in which money was collected from customers for the purpose of purchasing securities for them, and the securities were never purchased. The money received from customers was deposited in the corporate account. The court held that there was no coverage under the bond since the insured had suffered no loss, but owed money to the customers. This is the same situation that prevails in the instant case.

The proof in the instant case is that money was collected for customers for the purpose of purchasing municipal bonds and that the bonds were never purchased. The proof is clear that all such money so obtained was deposited in the Dean Company account and all was a matter of record on the company books. The money was disbursed by the corporation for normal operating expenses and in the form of loans and salary to Dean and Nichols. Under these circumstances there was no covered loss. The fact that Dean and Nichols may have used money from their personal funds to purchase stock in other companies, or to gamble in Las Vegas, or for whatever purpose, has no bearing on the matter.

The case of *Bass* v. *American Insurance Company*, 493 F 2d, 590 also cited by appellant is further authority for the fact that there was no covered loss involved in the present case.

In the Bass case, as in the present case, the trustee in bankruptcy brought suit against the bonding company, wherein there had been a failure to purchase bonds for delivery to customers, and the funds obtained from the customers were

deposited in the company's general account. The court here again held that there was no coverage under the bond and no covered loss, and this finding was affirmed on appeal.

POINT III

The directors of the Dean Company were the alter-ego of the corporation.

The following are indicia of alter-ego. First, the diversion of corporate funds or assets to other than corporate uses. Second, the treatment by an individual of the assets of the corporation as his own.

Both Dean and Nichols handled corporate assets in this regard. Both Dean and Nichols disregarded the corporate entity and were partners. The corporation was simply organized to avoid recourse by creditors to personal assets. They were, in fact, partners and equitable owners of the corporation. They treated the assets of the corporation as their own and added and withdrew capital at will. The separate personality of a corporation is but a statutory privilege and must not be used as a cloak for evasion of personal obligations. To recognize the fiction of separate corporate existence would further a fraud on the Aetna. The bond does not cover loss resulting from from any fraudulent or dishonest acts of any partner of the insured.

Fletcher v. *Cyclopedia Corp. Perm Ed.* Vol 1, Sec 41.3

McKee v. *American Casualty Co.*, 316 F 2d, 428 (1963)

Where the corporate fiction is merely an alter-ego or business conduit it may be disregarded in the interest of securing a just determination of an action.

18 Am. Jur. 2d, P 562.

POINT IV

Neither the insured nor the appellant trustee has complied with the terms and conditions of the bond.

Neither the insured nor the appellant trustee has ever filed a proof of loss with full particulars as required by the bond. No action for recovery can be maintained until 60 days after filing such proof of loss (See Section 4 of the Bond).

Justin Vigdor was appointed as assignee for the benefit of creditors on April 4, 1973.

Aetna furnished to Mr. Vigdor, the assignee for the benefit of creditors of the insured Dean Company, forms on which to submit a valid proof of loss and he was advised by Aetna that an affirmative proof of loss was required by the bond. (R 322, 323). Mr. Vigdor conceded at the trial that he never, at any time, filed a proof of loss (T 370, 371).

Judge Burke properly found as a fact that no valid proof of loss was ever filed by the insured or by Mr. Vigdor or by the plaintiff. (Appendix P 41).

Failure to file a proper proof of loss bars recovery.

> *Mt. Vernon Bank & Trust* v. *Aetna Casualty and Surety Company*, 1963 (224 F Supp 666)
>
> *Hidden Splendor Mining Co.* v. *General Insurance Company of America* (1966) 370 Fed 2d, 515 (10th Cir.)

The requirement of notice and filing of proofs of loss is a condition precedent to the insured's liability.

> Couch on Insurance, 2d Edition, Section 49:478

Appellant's argument that Aetna waived the requirement of proof of loss by refusing to make payment in their letter of September 4, 1973 (Exhibit 25) seems somewhat specious since the refusal to make payment was on the ground that no proof of loss had been filed, among other things.

CONCLUSION

By reason of the foregoing, the Order and Judgment of Judge Burke dismissing the Complaint herein should be affirmed in all respects.

Respectfully submitted,

WINCHELL, CONNORS AND CORCORAN
Attorneys for Defendant-Appellee
45 Exchange Street
Rochester, New York 14614

On the Brief:
RICHARD H. CONNORS

EXHIBIT A

NEW YORK LAW JOURNAL (4-1-75)

New York County—Supreme Court

Justice Amsterdam

KELLY, ANDREWS & BRADLEY, INC., v. U. S. FIDELITY & GUARANTY CO. — The decision of Dec. 31, 1974 is recalled and the following is substituted in lieu thereof.

Motions under calendar numbers 154 and 155 of Oct. 31, 1974 are consolidated for disposition.

Plaintiff moves for partial summary judgment on the issue of liability pursuant to CPLR 3212 and defendant moves for an order of preclusion against plaintiff or for a further bill of particulars.

Plaintiff herein is the Trustee of Kelly, Andrews & Bradley, Inc., appointed by order of the United States District Court for the Southern District of New York on Dec. 22, 1971 to effect liquidation pursuant to the provisions of the Securities Investor Protection Act of 1970.

In 1969, the corporation procured from defendant, United States Fidelity and Guaranty (Fidelity) a broker's blanket bond (No. 02-42-69), attached to plaintiff's moving papers as Exhibit "A" insuring against "any loss through any dishonest, fraudulent, or criminal act of any of the employees." The bond was periodically renewed and was in continuous effect from Jan. 1, 1960 to Jan. 1, 1972 and finally canceled in January 1972, after plaintiff's appointment as trustee for non-payment of premium.

Plaintiff commenced the present action to recover from Fidelity $250,000, the face amount of the bond, in partial satisfaction of losses sustained by the corporation while the bond was in effect. Plaintiff concedes the culpability of three "em-

ployees", Schiffman, Miller and Scheer, as a result of fraudulent and dishonest manipulations. Schiffman was indicted and pleaded guilty to conspiracy to commit fraud. As a result of this fraud, plaintiff alleges that the corporation lost the bulk of its funds. None of these three has attempted to intervene, nor otherwise dispute the above.

In addition, Schiffman, Scheer and Miller were the sole directors of the corporation and Schiffman the sole shareholder of record during the period that the alleged losses occurred. Plaintiff, however, seeks to ignore their corporate status and merely casts them as "employees."

Plaintiff, also seeks in his moving papers to show that the five affirmative defenses raised by Fidelity have no legal validity. The court will deal with the fourth affirmative defense which invokes section 3 of the bond, which states as follows:

"Section 3. The insured shall give to underwriter written notice of any loss under this bond as soon as possible after the insured shall learn of such loss."

Fidelity claims that the insured failed to notify it immediately upon discovery of the loss in question. Plaintiff alleges, however, that the persons who normally would have discovered the loss were responsible for it. If Schiffman, Scheer and Miller were mere employees, their knowledge of a fraudulent loss would not be imputed to the corporations where the employee was, in fact, responsible therefor. This is the settled law in New York (12 N.Y. Jurisprudence, Corporations, section 691, pp. 205, 206). As directors, however, having control of all the activities of the corporation, their knowledge is imputed to the corporation (3 Fletcher, Encyclopedia Corporation, Perm. Ed., sec. 808). Thus, it has been held that knowledge of the president of a corporation, as president, and of the president and his brother "as owners of all the stock of the * * * corporation, and the knowledge of the whole of its board of directors, is imputed to

the corporation itself and it is held to have knowledge of the same facts [cases cited omitted]" (Richmond Hill Realty Company v. East Richman Hill Land Company, 246 App. Div. 301, 305).

Moreover, as stated in Kerr v Aetna Casualty & Surety Co., (350, F. 2d 146 at 154); "(s)uch a bond is not intended to cover the fraud and dishonesty of men who are in effect the sole stockholders as well as the only directors of a closely held corporation * * * (t)he bond is intended to protect the corporation from the fraud or dishonesty of its employees, not to protect the corporation from the fraud or dishonesty of its stockholders and directors."

Accordingly the motion by plaintiff for partial summary judgment is denied and pursuant to CPLR 3212(b) summary judgment is granted to defendant.

EXHIBIT B
EFFECT OF DISCOVERY OF LOSS
FRANCIS L. KENNEY JR.
II. The Hypothetical X Corporation

When is there discovery (including both knowledge and information) of a loss situation when the Insured party involves a corporation which is dominated by an individual, either through stock ownership or by his knowledge of the business the corporation is engaging in, against whom subsequent management of the corporation makes a claim against a fidelity bond because of alleged acts of this individual?

To state the problem another way, "What is the effect of discovery (including information and knowledge) upon the obligations (including rights and duties) of parties (including the corporate insured, the bonding company, and the individual principal dominating the corporation against whom claim is made) when the claim is for loss alleged from acts of this same individual who dominated the corporation and who was instrumental in organizing it?"

At what point should the Court telescope the corporate entity back into the individual(s) who organized it and thereby collapse the corporation? It is the writer's opinion that where there is fraud of an individual(s) substantially controlling a corporation which continues throughout the life of the corporation and which would warrant piercing the corporate veil at the suit of a creditor, then there is no legitimate corporate entity, which as an obligee, is entitled to make claim against an Insurer for loss claimed to result from acts of this same individual(s).

Let's take a hypothetical case. A, B, and C are three individuals who form the X corporation. C is the managing officer who makes deals, handles the money, hires and fires employees and has the complete confidence of A and B. A and B can be either the wife of C and his young son just turned twenty-one, or

can be two individuals with whom C has been in deals with, and doing business with for a number of years.

The stock ownership can be in a number of ways. For example, if the ownership involves C and his wife and son, it can be in any percents because C is the dominating personality in the corporation. If it involves the two individuals A and B with whom C has been dealing for a number of years, it can be either a majority percent to C with a minority interest in A and B or it can be the reverse.

At some point after incorporation C as president and treasurer of the corporation takes out a fidelity bond on himself in the amount of $100,000. He continues as president and treasurer for a number of years, making deals involving the corporation, making deals that involve himself personally, writing checks of the corporation in payment of the corporate deals and also in payment of his personal deals which include paying for his airline transportation for vacations, paying for his wife's car, paying for his life insurance, and paying for stock in other corporations.

Then say either one of several alternatives happens.

1. C dies;

2. C has a falling out with his wife and divorces her or vice versa, or C has a falling out with his other two officers A and B with whom he has been making deals, and turns over his stock to the other stockholder-officers; or

3. C along with A and B arrange to sell the corproate stock to L, M and N with whom there have been no previous dealings of any kind.

In any event, the new management hires auditors and the resulting report discloses all the things that now appall the new stockholders and directors. The auditors' report also mentions

the bond on C as president and treasurer for $100,000. The new president, who may be either the estranged wife, the former inactive officers A or B, or one of the new stockholders L, M or N, then gives the bonding company written notice that it is making claim on behalf of the X corporation for the total amount shown by the auditors' report amounting to say $250,000 subject to the bond penalty of $100,000. Subsequently a proof of loss is filed setting out each of the acts complained of in detail and supported by the report of the auditing concern.

The bond on C is a form which agrees to indemnify the X corporation against any dishonest acts of the President-Treasurer, who is designated as an employee throughout the bond. There is a cancellation or termination clause which states that it shall be deemed cancelled as to any employee immediately upon discovery by the insured or by any partner or officer not in collusion with such employee of any dishonest act on the part of the employee. There are, of course, the standard clauses as to notice and proof of loss.

In resolving the problems presented by the above hypothetical situation, there is the necessity of attempting to get to the substance of the matter. When a bond runs to the X corporation, as this bond does, and the X corporation can only act through its directors and officers, can one or more of those officers, who are also directors, be an employee? With this, when knowledge of the acts of the President-Treasurer can only come to the other officers either through the President-Treasurer or from an examination of the transactions, including check signing and cashing of the President-Treasurer, then (a) is the knowledge of the President-Treasurer the knowledge of the corporation; and, (b) is knowledge obtained by other officers (also directors and stockholders) from participating in resolutions and corporation activities, the knowledge of the corporation which constitutes discovery within the definition of discovery or knowledge in the bond?

In *Kerr* v. *Aetna Casualty and Surety Company*, a Fourth Circuit case decided in 1965, and reported in 350 F.2d 146, Judge Thomsen said:

> Aetna further argues that even if there was a loss, and such loss was due to fraud on the part of Cudd or Coan or both of them, there still can be no recovery for these write-offs because Cudd and Coan were not "Employees" of the Underwriters within the meaning of the bond. . . .
>
> As shareholders of Underwriters, Cudd and Coan elected themselves its sole directors, and as directors they elected themselves its chief executive officers. Since the charter gave the directors the right to manage and control the corporation, Cudd and Coan as directors probably had the technical right to control Cudd and Coan as officers. But such a theoretical and unrealistic right of control did not make Cudd and Coan "Employees" of Underwriters covered by the bond. Such a bond is not intended to cover the fraud and dishonesty of men who are in effect the sole stockholders, as well as the only directors of *a closely held corporation.* As above noted, the bond is intended to protect the corporation from the fraud or dishonesty of its employees, not to protect its creditors from the fraud or dishonesty of its stockholders and directors. We cannot agree with the District Judge that the claimed loss as a result of the write-off of the debits resulted from the activities of Cudd and Coan as "Employees" of Underwriters. (pp. 154, 155, italics added)

Here the crux of the matter is in the fact that the corporation was in the words of the Court "a closely held corporation." This seems to answer the first question whether such officers, who are also directors and stockholders, are employees — and the answer is they are not employees.

In a Maryland district court case decided in July of 1966, *Phoenix Savings and Loan, Inc.* v. *Aetna Casualty and Surety Company*,[13] the Court said:

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[13] 266 F.Supp. 46 (1966, DCMd.)

In addition to the number of persons involved in the questioned transactions, the number of the transactions and the length of time over which they occurred persuades the court to impute knowledge of the transactions to the corporation as a matter of law. In 3 Fletcher, Corporations §826 at 146 (1965), the author remarks that

"an attempt has been made to differentiate a single fraudulent act of a corporate officer or agent from a series of fraudulent acts running over a long period of time . . ."

Such a distinction was made in Orme v. Baker, 78 N.E. 439 (Ohio 1906), where defendants argued that knowledge of certain officers, who had been engaged in fraudulent activities, should not be imputed to the bank because the officers' interests had been adverse to the banks. The court, at 442, treated this argument as follows:

"In other words, (the argument is that) they had been and were occupying a position with reference to the business of the bank, adverse to its interests, and while they were agents of the bank for some purposes, and in all things in the line of duty within the scope of their authority, yet they did not represent it in their fraudulent appropriations of its assets. . . .

"If the wrongs committed by the cashier and Vice President had been confined to a single transaction, or to a few transactions with a brief period, there would be some room for the proposition made, that the bank should not be charged with their knowledge of its insolvent condition. But such was not the case. . . . (T)he fraudulent acts of the cashier and vice president consisted of many acts committed not at once, but during many months, perhaps years. . . . There was a protracted looting . . ." (p. 471)

and then the Court concluded:

In conclusion, where individuals have organized a corporation to line their own pockets, and where they

> control substantially all of the activities of the corporation, their knowledge of the fraudulent nature of each and every questioned transaction must be imputed to the corporation. Since the first of these transactions took place before the bonds became effective, the failure to disclose the transactions to the surety operated to discharge the surety from any liability for the fraudulent transactions. (p. 473)

and this seems the answer to the second question whether knowledge of the dishonest stockholder-director-officer is the knowledge of the corporation — and the answer is that such knowledge is the knowledge of the corporation.

There are cases contra, among which are the following:

American Surety Co. v. *State*, (1920) 76 Ind. App. 260 127 N.E. 844, which held the bonding company liable for acts of a bank president, despite the fact that subsequent to the issuance of the bond, the president and his brother became a majority of the board of directors, whereas before they had been a minority only; and,

The *Bryan* v. *Fidelity and Casualty Co.* (1932), 167 Wash. 305, 9 P.2d 86, which held that the bonding company of the secretary-treasurer, who subsequently became president, owning 49 1/2% of the stock of the corporation, with the right, acquired later, to buy 50% from the president, was nevertheless liable, apparently on the theory that the secretary-treasurer-president had escrowed the stock he was purchasing from the prior president pending payment for it.

Again, it is the writer's opinion that these cases were actually passing on form rather than substance, and the theory of them has been denied by the more recent cases such as the *Kerr* case and the *Phoenix* v. *Aetna* case (*supra*). And the substance of the issue is: Whether an employee can also be, and operate in the capacity of an employer? Whether a person or party can be both a principal on a bond and also an obligee? And whether a

corporate entity can disavow responsibility for and knowledge of the acts of an individual(s) which through the corporate fiction it has placed in controlling positions? The answer would logically and legally appear to be negative.

In the case of the hypothetical X corporation, it can be a question of when the corporation had knowledge. This question of whether a corporation has knowledge of what appears upon its books and records was answered in the case of *Curtis* v. *Connly*, a Supreme Court case decided in 1921 and reported in 257 U.S. 260, 42 S.Ct. 100, 66 L.Ed. 222, 226, where the Court said on the question of knowledge:

> This suit is brought upon the common-law right of the bank to recover for acts that diminished its assets. Therefore the question is whether the bank's claim is barred. The bank, of course, must be charged with knowledge of what appeared upon its books. It owned them; its stockholders had a right to inspect them. Guthrie v. Harkness, 199 U.S. 148, 50 L.Ed. 130, 26 Sup. Ct. Rep. 4, 4 Ann. Cas. 433. Hence it would seem, as suggested by the district judge, that, so far as concerns investments of a kind that national banks are not allowed to make, the bank was chargeable with knowledge from the beginning, and can found no claim upon them now. The parties to whom loans were made, and the specific character of the assets must also have been known at all times, so that the only misrepresentations were those concerning the credit of the debtors, implied by entering the claim at their face value in the books and reports.

The Court stated that it was the business and duty on the part of the directors to get some notion of the credits and assets of the bank, since it did not appear there would have been any difficulty in ascertaining at least enough to lead to further inquiry if they had. On these facts, and because the bank was charged with

knowledge of what appeared upon its books, the 6-year Rhode Island statute of limitations was applied.[14]

In the *Mutual Life Insurance Co. of New York* v. *Mooreman*, a Ninth Circuit case decided in 1966, and reported in 366 F.2d 686, 690, in a suit by a trustee in bankruptcy, the court there said that Hilkert, the nominal secretary-treasurer of the corporation, who had testified concerning the use by the president, since deceased, of the corporate cash for the president's private purposes that Hilkert, although he had testified he had no knowledge of the life insurance payments, according to the court should have been charged with such knowledge. The court stated: "Had he been performing the duties for which he now claims compensation he certainly would have known."

The *Connly* case points up the fact that a corporate entity, as such, can have knowledge of what is present on its books, records and paper documents, even though all the officers and/or the directors disavow such knowledge of what appeared on its books, because it owned them; and later the Court in the *Mooreman* case stated that the secretary-treasurer should be charged with such knowledge because had he been performing the duties for which he now claims compensation, he certainly would have known.

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[14] The Curtis v. Connly case and the Mooreman case (*infra*) indicate that in the case of a corporation there can be at least two kinds of knowledge. There is the knowledge of what appears on the corporate books. And when the acts complained of are documented openly and consistently then the corporation, the entity, has knowledge of what the books show. This is the Curtis v. Connly knowledge.

Then there is knowledge which can be charged to a particular officer because within the scope of the duties charged to him. This is the Mooreman knowledge.

In the Curtis v. Connly situation the knowledge is implied because the bank had the means of knowledge. In the Mooreman case the knowledge is implied because the officer should have known of the acts had he been performing the duties of his office.

In the case of the hypothetical X corporation, the officer C comes within the rule of the "sole actor." Under this rule it has been held:

> In case the business or transaction in question is intrusted to an officer or agent of the corporation who acts as its only authorized agent, then, although such officer in transacting the business acts for himself or if interested in the transaction adversely to the corporation, under such circumstances his knowledge is imputable to the corporation, for the reason that the officer is necessarily acting for the corporation in his official capacity and as its sole authorized agent and hence his knowledge must be imputed to the corporation. Cf., Fletcher Cyclopedia Corporations (Perm. Ed.), Vol 3, §827, pp. 151, 152.

This "sole actor" doctrine has the benefit of substantial authority. In *Federal Deposit Insurance Corp.* v. *Vest, et al.*, a District Court of Kentucky case decided in 1939 and reported in 28 F.Supp. 507, 508, the Court said:

> At all times referred to Morton was not only the president and chief executive officer of the Taylor National Bank but he owned 76 percent of its capital stock. The evidence convincingly demonstrates that he was in exclusive control of the bank and directed all its operations. The board of directors and loan committee were entirely dominated by him. He exercised the corporate will of the bank in all matters and the acts of all other officers were merely perfunctory. It was a typical "one-man bank." . . . The plaintiff relies upon the familiar exception to the general rule to the effect that the agent's knowledge will not be imputed to his principal where the agent in the particular transaction acts in his own interests adversely or antagonistically to his principal. This exception does not apply, however, where the agent or officer of a corporation is in such complete control of it and so dominant in its affairs as to be the sole agency through which the corporation exercises its will in participating in the particular trans-

action. Under such circumstnaces, the agent and the principal being practically identical, notice to or knowledge of the agent must of necessity be regarded as notice to or knowledge of the principal, even though the agent or officer may have an individual interest in the matter adverse to that of the principal. . . . When members of a board or committee representing a corporation surrender their powers to an individual, either within or without such board or committee, who completely dominates, and through whom only the corporate powers are exercised, such board or committee is the sole actor, with but a single will and purpose, or else the dominant individual is the sole actor, and the others are to be ignored as if they did not in fact, as they do not functionally, exist. However considered, the principle is the same. . . . While there appears some diversity of opinion as to the true rationale or foundation of the "sole actor" doctrine, its soundness is supported by the great weight of authority. Curtis, Collins & Holbrook Co. v. United States, 262 U.S. 215, 43 S.Ct. 570, 67 L.Ed. 956; Anderson v. Missouri State Life Insurance Company, *supra*; Skud v. Tillinghast, 6 Cir., 195 F. 1, 5; Munroe v. Harriman National Bank, 2 Cir., 85 F.2d 493, 111 A.L.R. 657; Connecticut Fire Insurance Company v. Commercial National Bank, 5 Cir., 87 F.2d 968; Maryland Casualty Company v. Queenan, 10 Cir. 89 F.2d 155.

The *Vest* case (*supra*) was appealed to the Sixth Circuit and decided in 1941 in a decision reported at 122 F.2d 765, 769. In this case the Sixth Circuit said:

> It is a principle of the widest application that equity will not permit one to rely on his own wrongful acts as against those affected by it but who have not participated in it, to support his own asserted legal title or to defeat a remedy which, except for his misconduct, would not be available. See U.S. v. Dunn, 268 U.S. 121, 123, 45 S.Ct. 451, 454, 69 L.Ed. 676, Independent Coal and Coke Co. v. U.S. 274 U.S. 640, 648, 47 S.Ct. 714, 717, 71 L.Ed. 1270.

Fletcher continues the explanation for the "sole actor" doctrine as follows:

> The reason for the rule is that, where the officer in question is the sole representative of the corporation, there is no one to whom to impart his knowledge and no one from whom he may conceal it. This exception is based on the theory that, since the corporation claims the benefit of the agent's act, it thereby subjects itself to the consequences of his knowledge.[15]

Knowledge of the officer has been imputed to the corporation in a number of situations involving various types of corporations.[16]

If the doctrine of the "sole actor" can be imputed to a corporation under the circumstances set out above where there has been domination of the corporation by an individual, then this "sole actor" rule applies to actions on a bond or fidelity insurance policy of the officer. This "sole actor" or "sole representative" or "sole operator" doctrine, it would seem, should permit the application of the equitable doctrine that a court of equity will not lend its aid to enable one to take advantage of his own wrong. The doctrine of implied notice,[17] or knowledge which charges a person, or a corporation, with notice of everything that he could have learned by inquiry is generally applicable in equity as well as law. It is also applicable to situations involving unclean hands.

It seems from the above that if the so-called principal under the bond is the controlling officer-director of a closely held corporation (who may or may not be a controlling stockholder)

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[15]Fletcher, Vol. 3 § 827.1, p. 154.

[16]Fletcher, Vol. 3 § 827.1, p. 157.

[17]*Cf.* 66 C.J.S., Notice, § 2, p. 636 and § 5, p. 638. Also *cf.* contra: 50 Am. Jur. Suretyship, § 343, p. 1131 on negligence of the insured in examining accounts of the principal.

then the effect of discovery, as to the actions of this officer-director, is to charge knowledge of such actions to the corporation from the first such dishonest act of this "sole actor" for the corporation.

Conclusion

From the cases referred to herein and the comments concerning the bond provisions, it is submitted that the effect of discovery under the title to this paper is to:

(a) Cancel the coverage upon the employee involved;

(b) Require the Insured to notify the Insurer of its claim;

(c) Require the Insurer to post the reserve required by the insurance laws of the states in which it is licensed;

(d) Permit the Insurer to notify the employee-principal that a claim has been filed by his employer under the bond;

(e) Permit the Insurer to investigate the claim as to matters which will not involve a pre-determination of the claim, either as to its correctness or as to its amount;

(f) Cause the avoidance of the bond from its inception where the knowledge of the facts of fraud or dishonesty predate the effective date of the bond;

(g) Cause the release of the surety where notice is not given within the time period of the bond nor is a proof of loss filed as required by the bond; and

(h) Cause the release of the surety where the discovery involves knowledge of the dishonest controlling officer-director of the corporation who is the party charged with the loss being claimed for.

Finally, the effect of discovery of a loss under a fidelity bond is to trigger the action provisions of the bond, which when properly complied with by an Insured will result in a claim payment by the Insurer.

In The

United States Court of Appeals

For the Second Circuit

JOSEPH E. CARGES, as trustee in bankruptcy of Paul R. Dean & Co. Inc.,

Plaintiff-Appellant,

vs.

AETNA CASUALTY AND SURETY CO.,

Defendant-Appellee.

TABLE OF CASES AND AUTHORITIES

Page of Brief

Affidavit of Service

Monroe County's
Business/Legal Daily Newspaper
Established 1908

11 Centre Park
Rochester, New York 14608
Correspondence: P.O. Box 6, 14601
(716) 232-6920

Johnson D. Hay/Publisher
Russell D. Hay/Board Chairman

The Daily Record

May 14, 1976

Re:
Joseph S. Carges v. Aetna Casualty and Surety Co.

State of New York)
County of Monroe) ss.:
City of Rochester)

Johnson D. Hay
Being duly sworn, deposes and says: That he is associated with The Daily Record Corporation of Rochester, New York, and is over twenty-one years of age.

That at the request of

Winchell, Connors and Corcoran, Richard H. Connors, Esq.

Attorney(s) for

Aetna Casualty and Surety Co.
On May 14, 1976
(s)he personally served three (3) copies of the printed ☐ Record ☒ Brief ☐ Appendix of the above entitled case addressed to:

Justin L. Vigdor, Esq.
Martin, Dutcher, Mousaw, Vigdor & Reeves
25 E. Main St.
Rochester, New York 14614

☐ By depositing true copies of the same securely wrapped in a postpaid wrapper in a Post Office maintained by the United States Government in the City of Rochester, New York.

☒ XX By hand delivery

John D. Hay

Sworn to before me this 14th day of May 1976

John S. May

~~Notary Public~~
Commissioner of Deeds